TAB A

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington D.C. 20554

In the Matter of	)	
AT&T Corp.	)	
Petition for Rulemaking To Reform Regulation Of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services	)	WC Docket No. 02-____

DECLARATION OF STEPHEN FRIEDLANDER

1. My name is Stephen Friedlander. I am a manager in the Law and Government Affairs Department at AT&T. My responsibilities include analysis of LEC financial data and tariff filings in support of AT&T's position on interstate access matters. I obtained a B.A. degree from Boston University in 1971 and a Ph.D. in economics from the University of Colorado in 1977.

2. I have calculated the Regional Bell Operating Companies' ("RBOC") rates of return for interstate special access services. These calculations are based on data the RBOCs filed in their ARMIS 43-01 reports. The ARMIS 43-01 report contains basic financial data - revenues, expenses, reserves, and investments - from which local exchange companies ("LECs") calculate their net returns and rates-of-return.

3. The data in the ARMIS 43-01 reports are provided on a state-by-state basis. That data includes the LECs' "net return" for special access (line 1915, column s), and the LECs'

"average net investment" for special access (line 1910, column s). Rates-of-return are computed by dividing the reported "net returns" by the reported "average net investments."

4. Because the data are reported on a state-by-state basis, my calculations aggregate the state data to obtain net return and average net investment at the company level. This calculation is very simple. All that is required is to sum the return and investment figures for special access in each state to obtain company-wide totals, and then calculate the percentage of total return to total investment for each company.

5. The results of these calculations are summarized in Exhibit 1 (attached). As illustrated by Exhibit 1, every RBOC has enjoyed substantially increasing rates-of-return every year since 1996, and last year these returns exceeded 37 percent for most of the RBOCs.

6. I have also provided a separate table (Exhibit 2) setting forth the RBOCs' annual revenues from special access since 1996. Once again, every RBOC has enjoyed substantial growth in special access revenues every year since 1996, and total RBOC/GTE special access revenues have more than tripled since 1996, from $3.4 billion to $12.0 billion.

7. As these results indicate, SBC's special access revenues in 2001 exceeded amounts that would have produced an 11.25% rate of return by $2.5 billion, allowing for a 40% marginal income tax rate. For the same year, Verizon, BellSouth, and Qwest earned amounts that exceeded an 11.25% return by more than $1 billion, $966 million, and $710 million, respectively.

RBOC SPECIAL ACCESS EARNINGS (IN THOUSANDS)

		Average Net Investment*	Net Return**	Rate of Return
BellSouth				
	1996	679,773	109,946	16.17%
	1997	763,053	133,008	17.43%
	1998	767,838	240,243	31.29%
	1999	898,339	290,944	32.39%
	2000	1,247,668	457,590	36.68%
	2001	1,525,302	751,379	49.26%
Qwest				
	1996	862,193	46,133	5.35%
	1997	856,845	116,455	13.59%
	1998	815,296	222,105	27.24%
	1999	944,811	304,047	32.18%
	2000	1,181,070	453,235	38.37%
	2001	1,206,625	562,002	46.58%
SBC				
	1996	1,753,989	221,594	12.63%
	1997	1,904,567	304,980	16.01%
	1998	2,147,399	526,036	24.50%
	1999	2,213,592	875,456	39.55%
	2000	2,907,473	1,257,433	43.25%
	2001	3,531,727	1,928,324	54.60%
Verizon* **				
	1996	2,385,403	51,012	2.14%
	1997	2,831,074	59,532	2.10%
	1998	3,402,154	290,073	8.53%
	1999	4,365,775	437,343	10.02%
	2000	5,101,276	797,119	15.63%
	2001	5,768,191	1,252,839	21.72%
Verizon (w/o NYNEX)				
	1996	1,714,759	47,364	2.76%
	1997	1,747,972	181,474	10.38%
	1998	2,228,025	302,309	13.57%
	1999	2,496,655	571,908	22.91%
	2000	2,801,863	836,684	29.86%
	2001	3,135,740	1,162,658	37.08%

* 1996-2001 ARMIS 43-01, Table I. Cost and Revenue Table, Special Access, Column (s), Average Net Investment, Row 1910.

** 1996-2001 ARMIS 43-01, Table I. Cost and Revenue Table, Special Access, Column (s), Net Return, Row 1915.

*** Verizon includes Verizon-North, Verizon-South and GTE.

RBOC SPECIAL ACCESS REVENUES (IN THOUSANDS)*

	BellSouth	Qwest	SBC	Verizon
1996	$508,929	$429,790	$1,217,546	$1,281,907
1997	$599,609	$566,877	$1,494,486	$1,639,877
1998	$762,893	$715,333	$1,954,938	$2,093,947
1999	$919,988	$921,313	$2,480,544	$2,810,671
2000	$1,233,258	$1,226,016	$3,405,544	$3,724,881
2001	$1,831,143	$1,528,226	$4,294,276	$4,353,031

* Source: ARMIS 43-01, Row 1090, Column (s).

I, Stephen Friedlander, declare under penalty of perjury that the foregoing is true and correct.

Stephen Friedlander

Executed on September 25, 2002.

TAB B

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of AT&T Corp. Petition for Rulemaking To Reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services	WC Docket No. 02-_____

DECLARATION OF JANUSZ A. ORDOVER
AND ROBERT D. WILLIG
ON BEHALF OF AT&T CORP.

I. QUALIFICATIONS

A. Professor Ordover

1. My name is Janusz A. Ordover. I am Professor of Economics at New York University, which I joined in 1973. At New York University, I teach undergraduate and doctoral level courses in industrial organization economics, the field of economics that is concerned with competition among business firms and upon which "antitrust economics" is founded. I have devoted most of my professional life to the study and teaching of industrial organization economics and to its application through antitrust law and policy.

2. In July 1991, I was appointed by President George Bush to the position of the Deputy Assistant Attorney General for Economics in the Antitrust Division of the United States Department of Justice ("DOJ"). In this post, I participated in the drafting of the 1992 Horizontal Merger Guidelines, which have been widely used by courts and antitrust enforcement agencies. I returned to New York University in 1993.

3. I have written extensively on a wide range of antitrust and telecommunications topics, such as mergers and joint ventures, predatory conduct and entry barriers. My antitrust articles have appeared in the *Yale Law Journal*, the *Harvard Law Review*, the *Columbia Law Review*, and many other journals, monographs and books, here and abroad.

4. I have lectured extensively on antitrust topics to the American Bar Association, the International Bar Association, and the Federal Trade Commission ("FTC"). I have participated in numerous hearings on the future of antitrust at the FTC. I have also lectured on antitrust policy at colleges and universities in the United States and abroad, and at many conferences and meetings sponsored by various legal organizations.

5. I have acted as a consultant on antitrust and other competition matters to the DOJ, the FTC, and the post-communist governments of Poland, Russia, and Hungary. I have also consulted for the World Bank and the Organization for Economic Cooperation and Development in Paris. I have acted as a consultant in numerous antitrust litigation and investigations, including market definition and anti-competitive conduct matters for the FTC, Department of Justice and private clients in the United States, Australia, Germany and the European Union.

6. I have been involved in telecommunications issues in a variety of forums, such as the FCC, the OECD, and as a consultant to AT&T, Telstra, TelstraClear, and the governments of Argentina and various Eastern European countries.

B. Professor Willig

7. My name is Robert D. Willig. I am Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University, a

position that I have held since 1978. Before that, I was Supervisor in the Economics Research Department of Bell Laboratories. My teaching and research have specialized in the fields of industrial organization, government-business relations and welfare theory.

8. I served as Deputy Assistant Attorney General of Economics in the Antitrust Division of the United States Department of Justice from 1989 to 1991. I also served on the Defense Science Board task force on the antitrust aspects of defense industry consolidation and on the Governor of New Jersey's task force on the market pricing of electricity.

9. I am the author of *Welfare Analysis of Policies Affecting Prices and Products*; *Contestable Markets and the Theory of Industry Structure* (with W. Baumol and J. Panzar); and numerous articles, including "Merger Analysis, IO theory, and Merger Guidelines." I am also a co-editor of *The Handbook of Industrial Organization*, and have served on the editorial boards of the *American Economic Review*, the *Journal of Industrial Economics* and the MIT Press Series on regulation. I am an elected Fellow of the Econometric Society and an associate of The Center for International Studies.

10. I have been active in both theoretical and applied analysis of telecommunications issues. Since leaving Bell Laboratories, I have been a consultant to AT&T, Telstra and New Zealand Telecom, and have testified before the U.S. Congress, the Federal Communications Commission, and the public utility commissions of about a dozen states. I have been on government and privately supported missions involving telecommunications throughout South America, Canada, Europe, and Asia. I have written and testified on such subjects within telecommunications as the scope of competition, end-user service pricing and costing, unbundled access arrangements and pricing, the design of regulation and methodologies for assessing what activities should

be subject to regulation, directory services, bypass arrangements, and network externalities and universal service. On other issues, I have worked as a consultant with the Federal Trade Commission, the Organization for Economic Cooperation and Development, the Inter-American Development Bank, the World Bank and various private clients.

II. PURPOSE AND SUMMARY OF TESTIMONY

11. In this declaration, we discuss the appropriate regulatory treatment of special access services provided by the regional Bell operating companies ("RBOCs"). As we have explained in previous filings, the Commission should refrain from regulating where markets are workably competitive. Where markets are functioning well, there is no justification for undertaking the daunting task of substituting regulation for market processes to establish optimal prices, quantities, technologies and business models.

12. We have also made clear, however, that when a local exchange carrier controls an essential facility in a relevant market, and has incentive to abuse its market power, regulation is not only appropriate but necessary. Competitive forces cannot constrain the pricing and quality decisions of firms with such market power, and they inevitably will charge supracompetitive rates and attempt to withhold critical inputs that would allow others to challenge their supremacy. The result is a misallocation of resources caused by supracompetitive prices, and possibly wasteful spending by the monopolist to preserve its dominance.

13. We have also made clear in the past that there is no one-size-fits-all regulatory scheme. Regulatory commissions should be free to develop new ways of replicating market forces that are less costly and cumbersome. In this regard, we applaud the Commission's

attempts to engage in precisely this type of experimentation in connection with regulation of special access services.

14. In the 1990s, the Commission shifted from traditional rate of return regulation of the RBOCs' (and other large incumbents') special access charges to a price cap method. The price cap regime originally contained numerous protections for consumers, such as the "sharing" mechanism (which required price cap reductions if the RBOCs' rates of return exceeded a certain threshold) and the X-Factor (which required annual reductions for anticipated gains in productivity). Significantly, the rate of return threshold under the Commission's previous rules was never higher than 17.25%: that level triggered 100% sharing by the RBOCs.

15. Ultimately, the Commission recognized that, to the extent possible, the best way to regulate RBOC special access rates was to subject them to competition from other facilities-based providers. Thus, even prior to the adoption of the Telecommunications Act of 1996, the Commission issued a series of orders designed to promote exchange access competition and eliminate the *de facto* monopoly franchises that the RBOCs had enjoyed up to that time.

16. As we explain in greater detail below, the economic structure of this market has hampered the emergence of special access competition. Nevertheless, some competitors were able to enter on a facilities basis in some dense urban areas and provide alternative access services for the largest business customers. Seizing upon this nascent "competition," the RBOCs petitioned the Commission for forbearance from existing dominant carrier regulations. In several proceedings involving forbearance requests by individual RBOCs, we filed testimony cautioning against the sweeping relief from

regulation that the RBOCs were seeking.[1] Our testimony showed that the deregulatory relief sought by the RBOCs was far broader than the scope of competition that they faced and, therefore, would deregulate RBOC special access rates even in relevant markets where the RBOCs faced little, or no, effective competition.

17. The Commission's 1999 *Pricing Flexibility Order*,[2] however, undertook a radical change from its prior regulatory schemes: the Commission established "triggers" that permit incumbent carriers to remove special access services from price cap regulation altogether. While acknowledging that the incumbent carriers continued to be dominant, the Commission decided that the incumbents could not exercise market power wherever they faced competition from competitive local exchange carriers ("CLECs") with sunk facilities. The Commission also adopted the triggers that, it predicted, would accurately measure the existence of irreversible competition in the geographically appropriate markets.[3]

18. The purpose of our testimony is to evaluate these predictions in light of the last three years of experience. We conclude that the conduct and performance of the RBOCs since 1999 provide unambiguous evidence that the RBOCs, far from facing effective

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[1] *See* Declaration of Janusz Ordover and Robert Willig on behalf of AT&T in CC Docket No. 99-65, *Petition of Ameritech for Forbearance from Dominant Carrier Regulation of its Provision of High Capacity Services in the Chicago LATA* (March 31, 1999); Declaration of Janusz Ordover and Robert Willig on behalf of AT&T in CC Docket No. 99-24, *Petition of Bell Atlantic Telephone Companies for Forbearance from Regulation as Dominant Carriers in Delaware; Maryland; Massachusetts; New Hampshire; New Jersey; New York; Pennsylvania; Rhode Island; Washington, D.C.; Vermont; and Virginia* (March 18, 2001).

[2] *Pricing Flexibility Order*, 14 FCC Rcd. 14221 (1999).

[3] *See id.* ¶¶ 3, 69-70.

competition for their special access services, enjoy monopoly power that is virtually unchecked. *See infra* Part III. The RBOCs' special access services generate returns on investment as high as *56 percent per year*—even using the RBOCs' embedded investment dollars in ARMIS as a measure of the RBOCs' net investment—and much higher rates of return on the forward-looking economic value of the RBOCs' investment. The RBOCs have been able to sustain large increases over their already excessive rates in recent years, and have failed to make even a gesture of reducing rates where the Commission has authorized downward pricing flexibility. Furthermore, we understand that the quality of service provided in return for these prices has been poor.

19. We also explain why, despite the RBOCs' high prices, supracompetitive returns, and poor service, virtually no significant entry by competitors has occurred. *See infra* Part IV. This absence of competitive reaction and market restraint is precisely what an economist should predict from the daunting and enduring barriers to competitive entry that protect the incumbents. Transmission facilities are characterized by large economies of scale and by sunk costs. Further, there are powerful barriers to entry by second-mover CLECs that would compete with incumbents that already possess facilities capable of serving all existing demand.

20. Finally, we explain that the harms of allowing the RBOCs to exercise unchecked market power go beyond high rates, but also will allow the RBOCs to impede competition from competitive providers of access and other local services, purchasers of access services, and consumers of telecommunications services. *See infra* Part V. Facilities-based entry can be thwarted by these tactics because competitors need access to incumbent loop-transport facilities both to deploy local switches and as a "bridge" for self-deploying

facilities. The Commission's rules have prevented CLECs from obtaining these facilities as cost-based UNEs and instead have forced CLECs to use the supra-competitively priced special access as a substitute. Pricing flexibility has also given the RBOCs the ability to heighten the perceived entry risks facing the CLECs by responding with deep price reductions whenever a competitor actually achieves facilities-based entry or by locking up customers needed by a potential entrant to support competitive entry. These strategies appear to have deterred entry that would have reduced prices and improved consumer welfare. Finally, the RBOCs' monopoly power over special access can harm competition in long distance services (and any "bundled" offering that contains long distance components), as the RBOCs increasingly have an incentive to use special access pricing to effect anticompetitive price squeezes against unaffiliated long distance carriers.

III. THE CONDUCT AND PERFORMANCE OF THE RBOCS SINCE 1999 HAS REFUTED THE COMMISSION'S PREDICTION THAT MARKET FORCES WOULD CONSTRAIN THE RBOCS' SPECIAL ACCESS PRICING.

21. As noted above, the Commission's 1999 *Pricing Flexibility Order* established "triggers" that, when satisfied, allow nearly complete deregulation of the incumbents' special access offerings. As we and AT&T showed previously, these triggers were misconceived. First, the Commission granted the MSA-wide deregulation of rates based on a showing that only a relatively small percentage of the relevant routes in the MSA had facilities-based competitive alternatives. Thus, these triggers permitted deregulation of a large geographic area—an entire MSA—even if collocation arrangements were limited to a few offices. Second, the triggers for the transport elements of special access were overbroad, because they authorized the deregulation of all of the transport rate elements even though the Commission's "fiber-based collocation" test generally indicated the

presence of competitive facilities along only one piece-part of transport – entrance facilities. Third, the channel termination trigger was even more flawed, because it permitted deregulation of channel termination rates based solely on the deployment of *transport* – a deployment that in no way implies that competitors have deployed their own loops.

22. Experience has now exposed the flaws in the Commission's prediction that the triggers actually measured the existence of sunk, competitive alternatives that constrain special access market power. Since receiving pricing flexibility for services producing a majority of their special access revenues, the RBOCs have earned increasing supra-competitive profits – whether measured on the basis of historical or economic costs. The quality levels of these services have declined over this same period. And despite charging higher prices for lower quality, the RBOCs' special access revenues and usage have continued to grow. The reason for this is simple. The RBOCs' special access customers have no effective alternatives.

A. The RBOCs Have Earned Large And Growing Supra-Competitive Profits From Their Special Access Rates.

23. In effectively competitive markets, returns significantly exceeding a competitive cost of capital are unsustainable because market forces limit prices over the long run to forward-looking, economic costs. Economic costs, of course, include the cost of obtaining debt and equity capital. But in competitive markets, debt and equity investors earn – and a company can pay – no more than the "normal" profits needed to compensate investors for the risk of the investment. Any attempt by a firm in an effectively competitive market to charge prices that would generate more than a normal, risk-adjusted rate-of-return would

cause the firm to lose business to other firms that limited their prices to the lower levels needed to attract and retain investment capital. It is precisely for these reasons that the very definition of supra-competitive profit is return in excess of risk-adjusted normal profits.

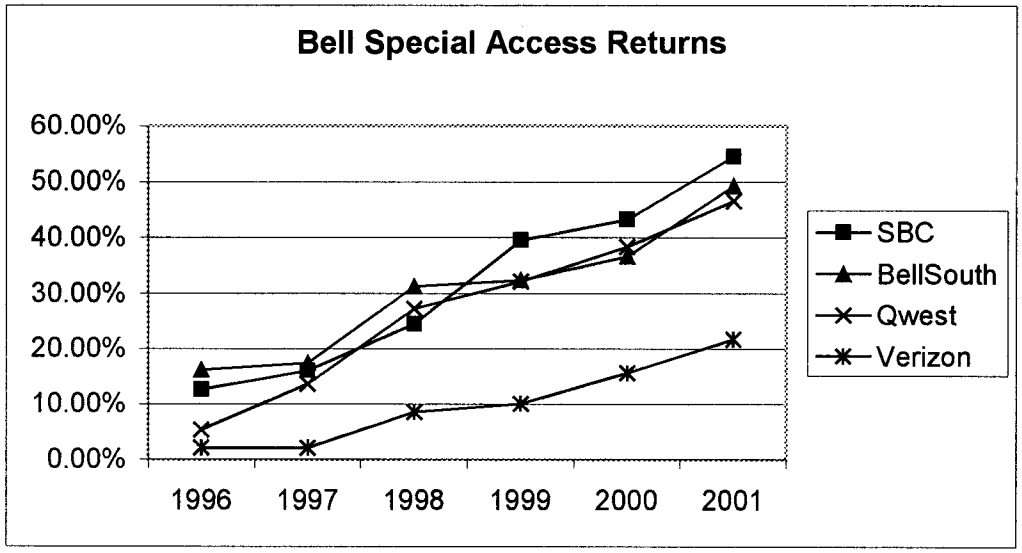
24. The returns being earned by the RBOCs on special access services are well in excess of those that would be earned by providers of special access facing effective market competition. The RBOCs' own ARMIS reports to the Commission establish that their rates of return on special access are multiples of the 11.25% rate of return that the Commission has previously found just and reasonable for dominant incumbent services. For 2001, the RBOCs' special access rates of return were as follows:[4]

BellSouth	49.26%
Qwest	46.58%
SBC	54.60%
Verizon	21.72%
Verizon (without NYNEX)	37.08%

25. These supra-competitive rates of return are the fruit of overcharges in dollar terms. For 2001 alone, the RBOCs' excessive special access prices generated approximately $5 billion of excessive earnings for the RBOCs from consumers and other downstream

[4] The figures and charts pertaining to the RBOCs' rates of return cited in this section are based on the work performed by Mr. Friedlander in his accompanying declaration.

customers.[5] The trend in the Bells' excess returns from special access is even more striking. As the following chart demonstrates, the RBOCs' interstate special access rates of return continue to grow every year, with no exceptions. Furthermore, the year-to-year increases are quite dramatic; each RBOC's rate of return is now at least five times higher, and in some cases *10 times higher*, than in 1996.



26. Even higher are the RBOCs' returns on the forward-looking economic value of their investment—the economically relevant measure of the return on investment. The costs reported on the RBOCs' ARMIS reports are, of course, embedded costs. And, as the Commission and the courts have consistently recognized, the RBOCs' true costs of providing services over their local networks are their much lower forward-looking

[5] Assuming an income tax rate of 40 percent, approximately $3 billion of these excess earnings are retained by the RBOCs as monopoly rents.

economic costs.[6] The RBOCs' special access rates exceed their economic costs by an enormous margin.

27. One way to estimate the magnitude of this margin is to compare the RBOCs' rates for special access services with the same carriers' rates for the most comparable loop and transport elements. Special access services are provided over the same facilities and are functionally equivalent to high capacity loop and transport unbundled network elements. Yet, the RBOCs' special access rates are generally at least double their comparable UNE rates. The Stith Declaration compares, on a state-by-state basis, the RBOCs' tariffed interstate special access rates with the rates for the comparable unbundled network elements in that state. For services still subject to price cap regulation, the RBOCs' month-to-month DS1 and DS3 special access rates are often more than 100% higher than the comparable UNE rates, and sometimes they are even 200% or 400% higher. Thus, if the RBOCs' annual special access returns are calculated on the basis of their *economic* costs, as indicated by UNE rates, rather than their embedded costs, it becomes clear that their real returns on these services are enormous – typically in excess of 100 percent annually. This is powerful evidence that the RBOCs have market power in the provision of special access services to end users and other carriers.

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[6] *See, e.g., Local Competition Order*, 11 FCC Rcd. 15499, ¶ 679 (1996) ("We believe that our adoption of a forward-looking cost-based pricing methodology . . . establish[es] prices . . . based on costs similar to those incurred by the incumbents."); *Verizon Communications Inc. v. FCC*, 122 S. Ct. 1646, 1672 (2002) (costs that exceed TELRIC are inefficient costs); *Alenco Communications Co. v. FCC*, 201 F.3d 608, 615 (5th Cir. 2000) ("rates must be based not on *historical, booked costs*, but rather on *forward-looking, economic costs*. After all, market prices respond to current costs; historical investments, by contrast, are sunk and thus ignored.").

B. The RBOC Pricing Behavior Provides Further Evidence Of Their Market Power in Special Access.

28. The RBOCs' pricing behavior offers yet further evidence that the RBOCs exercise substantial market power. As AT&T explains in its Petition, in *every* MSA where the RBOCs have obtained "Phase II" pricing flexibility (*i.e.*, removal of special access from price caps), the RBOCs have maintained or even *raised* their tariffed month-to-month special access rates. Indeed, both BellSouth and Verizon have increased their tariffed month-to-month special access rates in every MSA in which they have been awarded Phase II pricing flexibility since 1999.[7]

29. The effect of removing rates for special access from RBOCs' price caps can be measured directly because the Commission requires price-cap incumbent carriers to continue to file their rates in tariffs even after receiving Phase II pricing flexibility. As AT&T explains in its Petition, the tariffed rate in Phase II MSAs no longer subject to price cap regulation is equal to or higher than the rate for the same service in areas that remain subject to price cap regulation for virtually every special access service in every state for every Bell.[8]

30. It is our understanding that the RBOCs' have defended their rate hikes by citing the Commission's statement in the *Pricing Flexibility Order* (¶ 155) that "some access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in certain areas." But such a claim is unsustainable from an economic perspective. As the charts above show, the RBOCs' rates of return were

[7] Stith Decl., Exhibit 1.

[8] *Id.* The only exception is Ameritech's rates for OC-3; the pricing flexibility rate is one percent lower than the price cap rate.

already above any plausible measure of their cost of capital *before* the increases. Indeed, it is notable that after most special access has now been removed from price caps, the RBOCs have not seen fit to respond to any claimed instances of competition by lowering their generally available tariffed rates in *any* of those MSAs.

C. The Quality of Special Access Service Provided By The RBOCs Has Been Poor, But Revenues And Usage Have Continued To Increase.

31. Other evidence of the RBOCs' monopoly power over special access is the poor quality of their performance in provisioning special access services.[9] The Joint Competitive Industry Group, which represents a spectrum of purchasers of special access (including non-carrier end-user customers), has documented the poor quality of the incumbents' performance over the last few years.[10] The ability of the RBOCs to impose rates that earn ever increasing returns, while simultaneously lowering the quality of those services, is strong evidence that customers rarely have alternative sources of supply.

32. At the same time, interexchange carriers ("IXCs") and other competitive local carriers have been increasingly forced by the lack of regulatory or competitive alternatives to rely on the Bells' deregulated access services, even to provide competitive local services. As explained in the accompanying Declaration of Mr. Friedlander, each of the RBOCs has experienced double-digit annual growth in special access usage.[11] As a consequence of increasing prices and increasing volumes, overall RBOC special access revenues have

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[9] *See* Notice of Proposed Rulemaking, *Performance Measures and Standards for Interstate Special Access Services*, CC Docket No. 01-321 (Nov. 19, 2001); Comments of AT&T, CC Docket No. 01-321 (filed January 22, 2002).

[10] *See* Comments of AT&T, CC Docket No. 01-321 (filed January 22, 2002).

[11] *See* Friedlander Decl. ¶ 6 & Exhibit 2.

more than tripled since 1996, from $3.4 billion to $12.0 billion. All RBOCs have participated in this trend, which has accelerated in recent years.

33. Of course, if viable alternatives to the last mile of the RBOCs' facilities actually existed, the RBOCs would not be able to impose large rate increases, lower quality, and simultaneously increase overall usage of their networks. Nor have carriers been able to use UNEs to bypass the RBOCs' special access services. As we explain below, and as AT&T has explained in even greater detail in the Triennial UNE Review Proceeding, because of the Commission's use and commingling restrictions on enhanced extended links ("EELs"), IXCs and CLECs must rely on RBOC special access to provide both exchange access *and* local service.

IV. HIGH BARRIERS TO ENTRY HAVE ALLOWED FEW COMPETITIVE ALTERNATIVES TO THE RBOCS' SPECIAL ACCESS SERVICES DESPITE THEIR HIGH PRICE AND LOW QUALITY.

A. The Marketplace Evidence Confirms That There Are Few Alternatives To RBOC Special Access Services.

34. An equally significant indication of the RBOCs' ability to maintain their monopoly power over special access is the absence of significant new facilities-based entry in response to the high price and low quality of the RBOCs' services. Three years after the Commission began its experiment in deregulation, facilities-based competition for special access remains limited, costly, inefficient and unreliable.

35. AT&T has provided substantial evidence, both in the testimony accompanying this filing and in the Triennial Review Proceeding, that, despite billions of dollars in investments, AT&T and other CLECs have been able to replicate only a small fraction of the Bells'

high-capacity network.[12] Indeed, even when AT&T has self-deployed fiber transport rings, it remains generally dependent upon the ILECs both to provide local loops and to provide transport to aggregate traffic from low demand central offices to hubs where the fiber ring is deployed.[13] The result is that the lion's share of AT&T's access dollars go to the Bells.[14]

36. Moreover, AT&T's opportunities to expand its use of facilities-based alternatives are severely limited. As explained in the separate declaration of Ken Thomas, only a small fraction of the buildings where AT&T currently purchases special access have sufficient demand that it would be even theoretically feasible to consider the deployment of alternative facilities. And even then, AT&T, as well as other CLECs, are often unable to secure the necessary rights-of-way, or convince customers to switch away from ILEC-provided loops.

37. Nor, as Mr. Thomas explains, can AT&T turn to other CLECs, because they too have established alternative facilities to only a small fraction of buildings. AT&T has contractual arrangements with virtually all of the major CLECs that offer facilities-based access services, such as MFS/WorldCom, Adelphia, and Time Warner. These CLECs, however, can provide access to only a small number of additional buildings nationwide.[15]

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[12] *See* Comments of AT&T Corp., CC Docket No. 01-338, at 148-58 (filed Apr. 5, 2002) ("AT&T Triennial Review Comments"); Reply Comments of AT&T Corp., CC Docket No. 01-338, at 179-87, 257-67 (filed July 17, 2002) ("AT&T Triennial Review Reply Comments").

[13] *See* AT&T Triennial Review Comments at 149-50; AT&T Triennial Review Reply Comments at 294-96.

[14] *See* AT&T Triennial Review Reply Comments, Pfau Reply Dec. ¶ 26 n.10.

[15] *See* Thomas Dec. ¶¶ 6-7.

Further, even where AT&T has a contractual arrangement with a CLEC, AT&T often cannot use that CLEC to provide access.[16]

B. The Transmission Facilities Used To Provide Special Access Services Have Monopoly Characteristics And Are Protected By High Entry Barriers.

38. The record from the Triennial UNE Review Proceeding demonstrates that, because of basic economic and network engineering considerations, competitors will be able to deploy alternative facilities in only limited circumstances. Loop and transport facilities are characterized by substantial economies of scale and sunk costs. Thus, in most instances, replicating incumbent transmission facilities would be economically wasteful. And even in those few instances where self-deployment can be economically justified, barriers to entry -- such as the inability to obtain necessary rights-of-way in a timely fashion -- often prevent competitive deployment of facilities.

39. *Transmission Facilities Are Characterized By Substantial Economies Of Scale.* We understand that most of the cost of deploying loops, including "high capacity" loops, is in the supporting structures, placement, rights of way, and access to buildings, and not in the conductors (fiber strand or copper wires) themselves. The costs of the actual conductor – be it copper or fiber – represent only a small portion of the overall deployment cost.

[16] As Mr. Thomas explains (¶¶ 8-11), many CLECs have overstated the extent to which they have buildings "on-net," most of the major CLECs that provide alternative access have gone bankrupt, and capacity on wholesalers' networks is also often very expensive, because wholesalers typically price their services just under the price umbrella of the Bells' special access services.

Because the costs of supporting structures are relatively insensitive to the number of wires or fiber deployed, the Bells enjoy substantial economies of scale.[17]

40. Dedicated transport is also characterized by substantial economies of scale and scope.[18] Not only do the Bells have fiber interconnecting virtually all of their central offices (either directly or indirectly), they also generally deployed dark fiber capacity at the time of the initial facility construction, so they can dramatically increase lit capacity on most routes simply by adding or upgrading the terminating electronics at relatively small incremental costs (and certainly at a trivial cost compared to new construction). Thus, even on specific, high-demand point-to-point routes, a CLEC cannot hope to achieve the per-unit cost of the Bells' transport.

41. *Transmission Facilities Are Characterized By Substantial Sunk Costs.* The difficulties in self-deploying transmission facilities in competition with incumbents are compounded by the sunk character of the costs of building loop and transport facilities. An investment in an asset is sunk if, once made, it cannot be recovered by removing the asset from service. Invested capital funds spent on trenching, structure, and rights of way for a loop clearly fall into this category. It is basic economics that the need to incur significant sunk costs to deploy facilities that have substantial scale economies can result in significant entry barriers.

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[17] AT&T Triennial Review Reply Comments at 148-60.

[18] *Id.* at 148-52.

42. When substantial sunk investments must be made, an entrant may be reluctant to undertake an investment if there is a material risk that the costs of the investment will not be recovered. As one of us has previously explained:

> The reasoning for this is straightforward. If costs are sunk, the potential entrant knows that it will not be able to recover its costs if it is unable to attract sufficient revenues to recover the sunk costs. At the same time, because of economies of scale, the new entrant will incur higher per-unit costs, making it difficult for it to win sufficient customers away from the incumbent. Further, because the incumbent has already sunk its costs and has very low marginal costs, there is a significant threat that the incumbent could drop its prices in response to competitive inroads at any time down to its short run costs.[19]

43. There is broad agreement among economists that industries characterized by *both* declining average costs *and* sunk costs have the properties of natural monopolies protected by economic entry barriers.[20] Thus, in such an industry, even if an entrant could reasonably approximate the scale economies of the incumbent, the threat that the incumbent would respond with prices close to the short term variable costs, thereby making it impossible for the entrant to recover sunk costs, may deter all but targeted, limited entry. The Commission has recognized this point.[21]

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[19] AT&T Reply Triennial Reply Comments, Willig Reply Dec. ¶ 21.

[20] W. Baumol, J. Panzar, and R. Willig, CONTESTABLE MARKETS AND INDUSTRY STRUCTURE (1982); D. Carlton and J. Perloff, MODERN INDUSTRIAL ORGANIZATION (3rd ed. 2000).

[21] *See Section 257 Report*, 12 FCC Rcd. 16802, ¶ 18 n.48 (1997) ("If entry into an industry requires large sunk costs, the firm that incurs these sunk costs first (the incumbent) can have a tremendous advantage. Potential new entrants may realize that any large scale facilities-based entry into the market will probably force prices to decrease and those prices may be in fact below the point necessary to recover the sunk cost investment. As a result, facilities-based entry will be deterred."); *see also MCI-BT Merger Order*, 12 FCC Rcd. 15351, ¶ 162 (1997) (same).

44. *ILECs Have Enormous First-Mover Advantages.* Finally, the Bells enjoy first mover advantages over any CLEC that further compound the entry risks and create disincentives to entry. As first movers, the Bells received rights-of-way from local governments for underground cables, telephone poles and wires with only minimal transactions costs, because potential telecommunications customers in the neighborhood or municipality otherwise would not receive any telecommunications services. Similarly, building owners and landlords welcomed and accommodated Bells that were the only viable provider of telecommunications facilities to their properties. As subsequent entrants, CLECs, on the other hand, generally cannot rely on existing facilities, rights of way, or conduit.[22] Rather, a CLEC must construct the loops and transport from scratch, which takes many months of pre-construction while, at the same time, it tries to negotiate the necessary rights of way and construction permits from the municipality and negotiate the terms of building access from the landlord.[23] Rather than welcoming additional competition, these entities often view CLEC requests for rights-of-way as a nuisance. Retail customers understandably do not wish to wait the many months necessary for the competitive carrier to negotiate through this thicket.[24] Further, whereas the Bells entered the pertinent markets free of competitors and, as a result, have facilities in place to serve all customers, CLECs must often commit to deployments based on projections or speculation that there will be demand for such facilities thereby facing higher market risk and thus potentially higher cost of capital.

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[22] AT&T Triennial Review Reply Comments at 164-65, 171-77.

[23] *Id.*

[24] *Id.* at 171-73.

45. CLECs must also incur substantial marketing costs to attract customers now served by the RBOCs. Unlike the RBOCs, which started with no competition, CLECs must expend significant sums to market their services, develop a brand and convince consumers to switch from their incumbent provider.[25] Thus, CLECs need to spend much more per customer on marketing efforts to win customers away from the RBOCs, and generally also have to underprice the RBOCs to obtain business. "[E]ntrants must entice customers with a lower price and/or incur a greater selling expense per unit than the incumbent(s). . . . As a result, . . . an entrant must incur promotional expenditures to overcome the incumbent's existing market dominance. Such expenditures are unrecoverable by the entrant in the event of market exit and may constitute, therefore, a sunk cost impediment to entry."[26] For all of these reasons, there is no sustainable basis to conclude that new entry can be relied upon to constrain the RBOCs' special access rates any time soon.

V. THE RBOCS HAVE THE ABILITY AND INCENTIVE TO USE THEIR MARKET POWER TO HARM USERS OF SPECIAL ACCESS AND STIFLE COMPETITION IN ADJACENT MARKETS.

46. As discussed above, the RBOCs have used their Commission-authorized pricing flexibility over special access to collect billions of dollars in supracompetitive profits. These rents are an unnecessary transfer of resources to the RBOCs from their customers and, ultimately, from consumers. The deadweight economic loss that results from this overpricing and the resulting suppression of demand for special access services and the

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[25] *UNE Remand Order*, 15 FCC Rcd. 3696 ¶ 87 (1999).

[26] *See First Video Competition Report*, 9 FCC Rcd. 7442, ¶¶ 39-40 (1994).

services they make possible, relative to the level of demand that would be forthcoming at competitive prices, is undoubtedly significant as well.

47. But this significant and unnecessary drain on the economy is only one of the manifestations of the RBOCs' special access dominance. Basic economics predicts that the RBOCs will have the incentive and ability to use their control over essential last mile facilities to impede competition in a number of adjacent product markets.

A. Strict Regulation Of Special Access Rates Is Necessary To Protect Facilities-Based Local Competition.

1. The RBOCs' Inflated Prices For Special Access Have Erected A Major Barrier To Entry By Potential Facilities-Based Competitors Into Retail Markets For Local Telephony.

48. High special access rates inhibit the entry of CLECs into local markets using their own facilities. Special access services are critical to local competition because the current regulatory regime does not allow CLECs to substitute combinations of loop and transport UNEs. As AT&T has explained, the Commission has permitted incumbents to impose "use" and "commingling" restrictions on combinations of unbundled loops and transport facilities that have largely prevented CLECs from converting special access services into unbundled network elements.[27] We understand that over 98% of AT&T's facilities-based *local* service for business customers using incumbent facilities of DS-1 level or higher is provided over incumbent special access services, not UNEs.[28]

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[27] Comments of AT&T Corp., CC Docket No. 96-98, at 18-23, (filed April 5, 2001) ("AT&T Use Restriction Comments"); AT&T Triennial Review Reply Comments at 283-300.

[28] *See* AT&T Triennial Review Reply Comments, Pfau Reply Dec. ¶ 26 n.10.

49. Without access to cost-based loop-transport UNE combinations known as EELs, CLECs depend on the availability of reasonably priced special access "services" to deploy CLECs' own switches and other local facilities. CLECs lack the geographically concentrated customer bases that the ILECs enjoy. Thus, to deploy switches with the same capacity (and, therefore, scale economies) as the ILECs, CLECs must be able to serve a more geographically dispersed customer base. Special access provides a necessary means to link potential customers to CLEC switches.

50. But, as explained above, special access rates are typically twice (and sometimes three or four times) the TELRIC rates for the comparable UNEs. And, critically, because TELRIC measures the incumbent's true economic costs, the fact that access rates are typically twice TELRIC means that the CLEC's cost of accessing the underlying facilities is usually twice (or more) that of the incumbent. Effective facilities-based competition is particularly difficult and unlikely under these conditions.

51. More subtly, CLECs need access to ILEC transmission facilities as a "bridge" mechanism to self-deploying their own transmission facilities in the few instances where it might be economic to do so. Because most of the investment in transmission facilities is likely to be sunk once made, competitive carriers are unlikely to be willing to build transmission facilities "on spec" and hope that customers will show up. Rather, potential entrants need some reasonable assurance that there is sufficient demand to support a deployment of transmission facilities. Customers, on the other hand, may be unwilling to commit to service and then wait the many months (or years) needed for the CLEC to obtain the necessary rights-of-way and build transmission facilities.

52. Further, the substantial economies of scale of transmission facilities render uneconomic the construction of a competitive carrier's own transmission facilities unless the carrier can aggregate traffic from numerous LSOs to a hub, and then place the aggregated traffic onto its own transport facilities at the hub.[29] Without access to EELs at TELRIC rates, CLECs face a dilemma. They can either pay excessive special access rates to reach those additional LSOs, thereby incurring excessive costs of purchased inputs from the RBOCs and burdening themselves with a cost structure that precludes them from competing effectively with the ILECs, or they can attempt to build fiber facilities with enormous excess capacity and substantial up-front costs that would dwarf the reasonably anticipated revenue stream. In either case, these costs – which the Bells do not face – impede effective entry into retail markets for local telephone services, and lessen the ability of competitive providers of telecommunications services to constrain the market power of the RBOCs.

2. The RBOCs' Ability To Engage In Targeted Pricing And Customer Foreclosure Also Acts as a Deterrent Against Facilities-Based Entry Into The Provisioning Of Special Access Services.

53. The existing rules not only enable ILECs to charge excessive prices for critical inputs that serve as a necessary bridge or complement to facilities deployment, thereby harming competition in the retail market for local telephony, but they also give RBOCs the ability to deploy discriminatory contract tariffs that can target any attempted competitive inroads into the intermediate market for special access. In particular, the existing pricing flexibility rules permit the RBOCs to price discriminate in a manner that may further

[29] *See* AT&T Triennial Review Comments at 136-38; AT&T Triennial Review Reply Comments at 251-52.

stymie entry or induce exit of efficient competitors and to use long term contracts to deny competitors access to the traffic necessary to justify facilities deployment.

54. *Targeted Pricing.* It has been noted that the RBOCs' excessive special access rates seemingly create a "price umbrella" over those CLECs that actually deploy alternative facilities. While this may be true for the few existing facilities-based CLECs, the presence of such an umbrella could offer little comfort to potential entrants. To the extent that an RBOC can price discriminate under the existing pricing rules, it will be able to lower prices selectively—*i.e.*, to only those customers that could potentially be served by the new entrant—while keeping prices high for all other customers. For example, if a competitive carrier were to deploy transport facilities between two points, an RBOC could respond by lowering prices on that route but not any others. Although such responses may, of course, occur in competitive environments, here it has the undesirable effect of prolonging market dominance by a firm that was able to make a large portion of its sunk investment in a regulated regime.

55. Thus, the RBOCs' option of cutting prices in response to facilities-based entry, coupled with the high degrees of scale economies, sunk costs, and second-mover disadvantages add up to a powerful deterrent to future competitive entry, unless the new entrant has substantial cost (*i.e.*, technology) or other advantages over the incumbent. Companies that would depend on the RBOC for critical inputs would, if anything, be even more unwilling to enter the market, because the likelihood of losses would be further elevated by the unreasonable prices that they would be required to pay to the RBOC for those inputs.

56. The Commission in its *Pricing Flexibility Order* was "concerned" about this: "Phase I relief, which enables [the Bells] to offer contract tariffs to individual customers, [could permit the Bells] to engage in exclusionary conduct."[30] The Commission observed that, absent regulation, the Bells had the ability to "reduce prices in the short run and forgo current profits in order to prevent the entry of rivals or to drive them from the market."[31] Because the Bell almost always enjoys substantial advantages over the CLEC in terms of per-unit costs, the Bell can reduce its rates to a point between its own unit cost and that of the CLEC at any time. As a result, the RBOC can deter or drive any CLEC from the market to the extent the CLEC's business plan is based on being able to charge prevailing supracompetitive access prices.[32]

57. The Commission believed that it could protect against these concerns by granting downward pricing flexibility only where CLECs had made "substantial sunk investment."[33] The Commission reasoned that where investment in alternative facilities had been sunk, the Bells would have no incentive to engage in exclusionary behavior because there would be little prospect of driving the CLECs out of the market. "If a competitive ILEC has made a substantial sunk investment in equipment, that equipment remains available and capable of providing service in competition with the incumbent, even if the incumbent succeeds in driving that competitor from the market."[34]

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[30] *Id.* ¶ 79.

[31] *Id.*

[32] *See* AT&T Triennial Review Reply Comments, Lesher Reply Dec. ¶ 28.

[33] *Pricing Flexibility Order* ¶ 80.

[34] *Id.*

58. The Commission's reasoning was too narrow. The sunk character of much of the investment in a competitive carrier's facilities does not eliminate the rationale for acting aggressively against an entrant when such aggressive behavior can reduce the likelihood of future additional entry in the same market or other markets. The economic literature cited by the Commission in its order pertaining to the incentives for "predatory" conduct focuses on situations where only entry in a single market by a single competitor is at stake. The incumbent's incentives, however, can change dramatically when multiple markets or entry by multiple carriers are involved. There is now a substantial economics literature demonstrating that an incumbent may want to use "predatory" actions (for example, price below some pertinent measure of cost) to establish a reputation for "toughness" and thereby dissuade subsequent potential entrants from invading its turf.[35] Thus, even though such conduct may be costly in the short run, it may nevertheless be a profitable business strategy if it lessens likelihood of entry over a long run.

59. The Bells' expert, Alfred Kahn, has agreed:

> The extent to which markets are effectively contestable cannot logically be independent of the ways in which the rich, dominant incumbents respond or have responded in the past to previous entrants. As my colleague Irwin Steltzer once put it, a no trespassing sign alone may not deter a hiker from walking on another's property, but when, just beyond the sign, the field is littered with the bodies of previous trespassers--and all the more so when other fields, owned by other people, are similarly littered--the lesson is likely to sink in. And no static calculus of the benefits and costs of such

[35] *See* X. Vives, OLIGOPOLY PRICING 291 (1999); D. Fudenberg and E. Tirole, Noncooperative Game Theory, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 320-322 (R. Schmalensee and R. Willig, eds. 1989); J. Ordover and G. Saloner, Predation, Monopolization and Antitrust, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 545-562 (R. Schmalensee and R. Willig, eds. 1989); D. Kreps, and R. Wilson, *Reputation and Imperfect Information*, 27 J. OF ECON. THEORY, 253-79 (1982); P. Milgrom, and J. Roberts, *Predation, Reputation and Entry Deterrence*, 27 J. OF ECON. THEORY 280-312 (1982).

> disciplinary action in an individual case, with the benefits heavily discounted because of their futurity and uncertainty, can suffice to dispel the possibility that such a policy will recommend itself to the incumbents, and end up producing a radically transformed, highly concentrated industry, far less competitive in its pricing behavior.[36]

60. *Customer Foreclosure.* The Commission has recognized a related concern that the RBOCs can use pricing flexibility to prevent facilities competition by engaging in customer foreclosure. In particular,

> [a]n incumbent can forestall the entry of potential competitors by "locking up" large customers . . . . Specifically, large customers may create the inducement for potential competitors to invest in sunk facilities . . . . To the extent the incumbent can lock in the larger . . . customers whose traffic would economically justify the construction of new facilities, the incumbents can foreclose competition for the smaller customer as well.[37]

61. The Commission's fears were well-justified from the perspective of sound economics. And there is now evidence that the pricing flexibility regulations that the Commission adopted in 1999 are not adequate to prevent this type of exclusionary conduct. As AT&T explains in its Petition, the RBOCs are effectively impelling carriers to enter into optional pricing plans ("OPPs") that tie up significant portions of the market. The RBOCs have threatened IXCs with even higher rates unless they sign long-term contracts with sizable penalties for early termination.

62. We understand that virtually all of these plans require AT&T to commit to certain levels of annual purchases to obtain the discounts. As a result, if AT&T were to migrate traffic to its own or RBOC competitors' facilities, it would lose the OPP discounts (typically on

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[36] Alfred E. Kahn, *The Macroeconomic Consequences of Sensible Microeconomic Policies*, at 14-15 (N/E/R/A Reprint, 1984).

[37] *Pricing Flexibility Order* ¶ 79.

a *regionwide* basis), which in most cases would dwarf whatever savings AT&T could achieve by using competitive alternatives. Indeed, we understand that some RBOCs have insisted on specific penalties for migrating traffic to competitors. Even if more broadly available alternatives were to eventuate, AT&T could not take advantage of them in many cases, because most of the OPP plans impose substantial penalties for early withdrawal, which would negate any savings.

63. In short, as the Commission recognized in the *Pricing Flexibility Order*, absent effective competition or regulation, the RBOCs have the ability to engage in pricing practices that make the technology-driven barriers to entry even more effective in working against new entrants. The RBOCs can ward off the threat of competitive entry by "locking up" large customers by offering them volume or term discounts below entrants' costs – thereby deterring prospective entrants, for whom service to large customers may have been the inducement necessary to invest in the necessary sunk facilities. And the evidence indicates that the RBOCs are doing precisely that.

B. Regulation Of Special Access Continues to be Necessary To Protect Long Distance Competition.

64. As the RBOCs win interLATA authority, they will have increasing incentive to use their market power in the provision of special access to disadvantage anticompetitively their long distance rivals. Access is a "necessary input for long-distance service" and access charges constitute a sizeable percentage of the overall cost of long distance services. This gives the RBOCs the opportunity to undertake a profitable strategy of raising rivals' costs.

65. More specifically, once RBOCs are permitted to provide in-region long-distance service, they will compete with the IXCs that depend on them for the provision of terminating and originating access. This provides the RBOCs with the further opportunity and incentive to weaken the IXCs' competitive position by overcharging them for access. At the same time, the increase in access charges will provide the RBOCs' long-distance affiliates with a strategic cost advantage wholly unrelated to any efficiencies realized by the affiliates. The source of these cost and competitive advantages is the difference between the true cost of access, as measured by its TELRIC, and the distorted rate that the RBOCs can charge to its access customers. This cost advantage enables the RBOC not only to charge monopoly prices for access, but to set its long-distance rates at or below its access prices.[38]

66. If access prices are above the costs that the RBOC actually incurs to provide access, the RBOC can use the cost differential between what its rivals pay them for these elements and the lower economic cost that it incurs as a vertically integrated company to gain an advantage in the provision of bundled services. The RBOC might create an anti-

[38] The Commission has long recognized that, "[a]bsent appropriate regulation, an incumbent LEC and its interexchange affiliate could potentially implement a price squeeze once the incumbent LEC began offering in-region, interexchange toll services." *Access Reform Order,* 12 FCC Rcd. 15982 ¶ 277 (1997); *see also id.* ¶ 278 (incumbents have the "incentive and ability to engage in a price squeeze"). As the Commission has explained, "[t]he incumbent ILEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause the competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges." *Id.* ¶ 277. Alternatively, "the incumbent LEC could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share." *Id.*

competitive price squeeze by charging IXCs a greater margin for access than the RBOC earns on its own integrated end-user services, and thereby deter efficient IXC supply. This strategy may be profitable to the RBOCs, while harmful to consumers, and can weaken the ability of IXCs to compete for local exchange business while maintaining the monopoly hold that the RBOCs have over that business.

67. Such ILEC tactics harm not only IXCs, but also telecommunications consumers. As long as the RBOC continues to charge and collect excessive access prices, it is the end users who will continue to pay for them in one way or another. One avenue is simply the passed-along amount that the end-user pays to the IXC, so that the IXC can in turn pay it to the RBOC. Another avenue is the above-cost price for long-distance charged to the end-user by the RBOC.

68. Consumers are also harmed because an anticompetitive price squeeze impairs the IXC's ability to compete for the provision of bundled offerings that contain both a local and long distance component. By maintaining above-cost access charges, the RBOC can continue to apply strong pressure on IXCs, who must charge customers long-distance prices that reflect the excessive charges. By charging prices for its long-distance customers that do not reflect all of the artificially elevated access prices, the RBOC can divert substantial business from the IXCs to itself.

69. The evidence since 1999 confirms that the Bells not only can undertake such anticompetitive price squeezes, but may have actually done so. For example, AT&T has shown that SBC maintains intrastate access rates in Texas of nearly six cents per minute

(originating plus terminating).[39] SBC's long distance affiliate, however, offers long distance rates in Texas as low as five cents per minute, as well as a block of 100 minutes for six dollars.[40] Because providing finished long distance service requires SBC to incur many additional costs (such as the intraLATA transport component, retail and marketing, and back office expenses), SBC's long distance affiliate must be offering retail services that fail to cover SBC's properly imputed costs. For an example that highlights the potential roles of bundling, BellSouth offers an intrastate service in its region called "Fast Packet Option." Under this offer, end users can obtain special access at rates that are lower than those in BellSouth's federal tariffs, but only if the end user agrees to purchase BellSouth's frame relay services as well.[41] As a result, AT&T cannot obtain special access at the "Fast Packet Option" rates and pair that service with its own frame relay services.

VI. CONCLUSION

70. For the reasons stated, the triggers established by the *Pricing Flexibility Order* fail to ensure that, absent regulation, an RBOC granted such flexibility would be unable to exercise market power over the access services for which pricing flexibility is authorized. Instead, the triggers have enabled the RBOCs to reap supracompetitive profits and freed the RBOCs to abuse their control of critical inputs in order to deter efficient entry into the

[39] Comments of AT&T Corp., CC Docket No. 00-175, at 4 (Nov. 1, 2001).

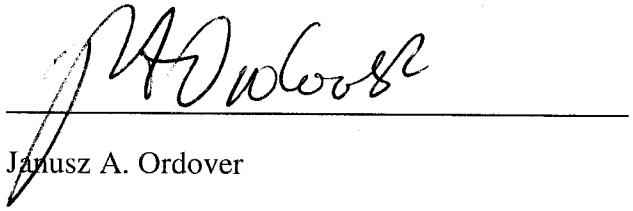
[40] *Id.*

[41] *Compare* BellSouth Telecommunications Inc., Georgia, General Subscriber Service Tariff, Twelfth Revised Page 1, A.40 (Frame Relay Service), *with* BellSouth Telecommunications, Inc., FCC Tariff No. 1, 6th Revised page 21-1 (Fast Packet Access Services). BellSouth has similar tariffs in each of the states in its region.

access markets and impede competition in long distance markets. Such consequences are plainly contrary to the public interest. We therefore recommend that the Commission subject the RBOCs' special access services to effective regulation that will drive access charges towards cost and constrain exclusionary conduct by the RBOCs.

VERIFICATION

I, Janusz A. Ordover, declare under penalty of perjury that the foregoing is true and correct. Executed on November 7, 2002.

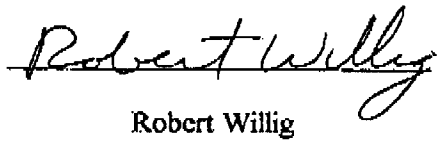


Janusz A. Ordover

VERIFICATION

I, Robert Willig, declare under penalty of perjury that the foregoing is true and correct.

Executed on October 14, 2002.



Robert Willig